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The Volcker Rule's Unintended Consequences

I. INTRODUCTION

In January of 2008, the French bank Société Générale announced that one mid-level trader lost the bank \$7.2 billion.¹ The losses incurred by the bank were the largest trading losses in banking history.² The activities of the trader greatly disturbed the financial markets, and as a result, it led in large part to the Federal Reserve making a historical rate cut of three-quarters of a percentage point to the discount rate.³ Although the trades were unauthorized by the bank,⁴ the employee's trading activities are considered proprietary trading.⁵ One way to characterize proprietary trading is trading activities that are for the bank's own account and "unrelated to customer trading."⁶

1. Nicola Clark & David Jolly, *French Bank Says Rogue Trader Lost \$7 Billion*, N.Y. TIMES, Jan. 25, 2008, at A1; Julie Satow, *How a Rogue Trader in France May Have Moved the Fed*, THE N.Y. SUN, Jan. 25, 2008, <http://www.nysun.com/business/how-a-rogue-trader-in-france-may-have-moved/70136> (stating that Monday's "sell-off" of stocks was exacerbated by Société Générale's decision to unwind the large positions taken by Paul Kievel, the rogue trader, in the derivatives market that amounted to as much as \$74 billion, leading to a historic rate-cut by the Fed).

2. Gregory Viscusi & Anne-Sylvaine Chassany, *Société Générale Reports EU\$4.9 Billion Trading Loss*, BLOOMBERG (Jan. 24, 2008), <http://www.bloomberg.com/apps/news?sid=a8GBEB7UuuXc&pid=newsarchive>.

3. Clark & Jolly, *supra* note 1.

4. *Id.*

5. See *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Banking, Hous. and Urban Affairs Comm.*, 111th Cong. 19-20 (LEXIS) (2010) [hereinafter *Prohibiting*] (statement of Paul Volcker, Chairman of the President's Economic Recovery Advisory Board and Former Federal Reserve Chairman) (stating that a single rogue trader in France cost a bank hundreds of millions of dollars when addressing proprietary trading losses in banks).

6. *Id.* at 10 (statement of Paul Volcker, Chairman of the President's Economic Recovery Advisory Board and Former Federal Reserve Chairman) (stating that the legislative intent of the Rule should be clear: the Rule prohibits banks from trading for their own account when it is unrelated to serving customers); see also Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13(h)(4), 124 Stat. 1376, 1630 (2010) (to be codified at 12 U.S.C. § 1851) ("[P]roprietary trading' . . . means engaging as a principal for the trading account of the banking entity . . . in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future

Even though proprietary trading was not the primary cause of the financial crisis,⁷ proponents of the Volcker Rule (Rule) nonetheless argue that restricting such activities is an essential piece of financial reform.⁸ The Rule bans “banking entit[ies]”⁹ from engaging in proprietary trading.¹⁰ Additionally, the Rule prohibits a banking entity from investing in or sponsoring a hedge or private equity fund¹¹ because such funds can be “alternate vehicle[s] for . . . conducting proprietary trading operations.”¹² However, a banking entity is able to make certain investments in hedge and private equity funds such as a de minimis investment of up to three percent of its “Tier 1 capital.”¹³ According to Paul

delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate . . . agencies . . . determine.”).

7. See Kim Dixon & Karey Wutkowski, *Volcker: Proprietary Trading Not Central to Crisis*, REUTERS, Mar. 30, 2010, available at <http://www.reuters.com/article/GCA-Economy2010/idUSTRE62T56420100330> (stating that Paul Volcker said that proprietary trading was not central to the financial crisis—“the very argument used by some critics of the proposal”). But see Stephen Gandel, *Is Proprietary Trading too Wild for Wall Street?*, TIME, Feb. 5, 2010, <http://www.time.com/time/business/article/0,8599,1960565,00.html#ixzzOyPtYK0mB> (stating that many large financial institutions that failed took large positions in proprietary trading and hedge funds and thus were a key driving force behind the financial crisis).

8. See Gerald Epstein et al., *The Real Price of Proprietary Trading*, HUFFINGTON POST (Feb. 23, 2010), http://www.huffingtonpost.com/gerald-epstein/the-real-price-of-proprie_b_472857.html.

9. Dodd-Frank Act, sec. 619, § 13(h)(1) (to be codified at 12 U.S.C. § 1851) (“The term ‘banking entity’ means any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. § 1813)), any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity.”).

10. The Rule also regulates nonbank financial companies governed by the Board, but this paper only focuses on banking entities. Instead of restricting proprietary trading and hedge and private equity fund activities, nonbank financial companies are subject to additional capital and quantitative limits with regard to these activities. However, the permitted activities are not subject to these requirements and limits. *Id.* sec. 619, § 13(a).

11. *Id.* But see *id.* sec. 619, §§ 13(d)(1)(G), 13(d)(4) (allowing additional exceptions to the general rule if the banking entity meets a number of requirements that are discussed more comprehensively below).

12. *Prohibiting*, *supra* note 5, at 24 (statement of Paul Volcker, Chairman of the President’s Economic Recovery Advisory Board and Former Federal Reserve Chairman).

13. Dodd-Frank Act, sec. 619, § 13(d)(4) (to be codified at 12 U.S.C. § 1851); Client Alert, Donald G. Kilpatrick et al., Pillsbury Winthrop Shaw LLP, Dodd-Frank Act: The Volcker Rule (July 21, 2010), <http://www.pillsburylaw.com/siteFiles/Publications/A4D5F0B7D37430E5BA1E4DC>

Volcker, the “plain intent” of the Rule is to reduce systemic risk to banking entities and the U.S. financial system by limiting high-risk trading activities in institutions that receive government support and protection.¹⁴ Many opponents of the Rule, however, believe that the Rule does not sufficiently address this goal and could adversely affect the safety and soundness of banking entities.¹⁵

What some have championed as legislation that reduces systemic risk and addresses the problem of too-big-to-fail may result in many undesirable and unintended consequences, while doing little to address the primary goal of the Rule.¹⁶ Critics of the Rule believe that it imposes substantial costs on the U.S. financial system and any benefits to financial stability attendant to the Rule are likely to be “illusory.”¹⁷ Now, “a small army of regulators” will

ACD68824C.pdf (“Tier 1 capital’ is the core measure of a firm’s financial strength from a regulatory perspective; it is composed of core capital, which consists primarily of common stock and disclosed reserves or retained earnings and may also include non-redeemable, non-cumulative preferred stock.”).

14. Letter from Paul A. Volcker to Timothy Geithner, Chairman, Fin. Stability Oversight Council (Oct. 29, 2010) (on file at www.regulations.gov) [hereinafter Letter from Paul A. Volcker]; see also Dixon & Wutkowski, *supra* note 7 (stating that proponents of the Rule believe that allowing banking entities to engage in proprietary trading and hedge and private equity fund activities will “distract [them] from serving clients”).

15. These people include many people in the banking industry, many Republican Senators, and Senator Chris Dodd to a certain degree. *Prohibiting*, *supra* note 5, at 47 (statement of Sen. Christopher Dodd, Chairman of the S. Banking, Hous. and Urban Affairs Comm.) (explaining that he did not want to have to go to the senate floor “begging for a [sixtieth] vote”); *Implications of the “Volcker Rules” for Financial Stability: Hearing on 111 H.R. 4173 Before the S. Banking, Hous. and Urban Affairs Comm.*, 111th Cong. 4 (LEXIS) (2010) [hereinafter *Implications*] (statement of Barry Zubrow, Executive Vice President and Chief Risk Officer at JPMorgan Chase).

16. Most banks will be able to comply with the Rule without making significant adjustments to their capital. See John Carney, *Why Wall Street Will Love The 3% Solution in Reform Bill*, CNBC.COM, June 25, 2010, <http://www.cnbc.com/id/37921692>; Daniel Indiviglio, *Dodd-Frank Bill’s Volcker Rule a Win for Big Banks*, THEATLANTIC.COM, June 25, 2010, <http://www.theatlantic.com/business/archive/2010/06/dodd-frank-bills-volcker-rule-a-win-for-big-banks/58747> (“The new limit will now give the banks an excuse to reduce the amount of capital they commit to a hedge fund, which was mostly done to convince clients that the banks had ‘skin in the game.’”); see also George Bollenbacher, *Viewpoint: Unresolved Questions on Volcker Rule*, AM. BANKER, Oct. 12, 2010 (addressing the uncertainty of the Rule and stating that many banks will still engage in many speculative activities).

17. R. Christian Bruce, *Regulatory Reform: McConnell Predicts Action on Dodd-Frank*, *Bachus Urges Global Focus on Volcker Rule*, BNA BANKING REP., Nov. 9, 2010 [hereinafter Bruce, *Regulatory*].

likely determine the effect of the Rule.¹⁸ However, taking a more inclusive view of the Rule may hurt U.S. banking entities' competitiveness, may limit banking entities' ability to successfully manage risks, and may tighten credit.¹⁹ If the Rule inhibits the competitiveness of the U.S. financial system, then it "will not serve [the] goal of [a] strong, stable economy."²⁰ Thus, to limit substantial costs to the U.S. financial system, regulators must limit the reach of the Rule and take into account its shortcomings.

This Note highlights how the Rule does not account for the primary purpose Paul Volcker envisioned, and concludes that restricting these activities is not the solution to the problem. However, through rulemaking, the applicable regulators may be able to create a workable Rule that limits the unintended consequences.²¹ To support this argument, Part II explores the recent financial crisis and shows that proprietary trading and hedge and private equity activities in banking entities played a small role in the financial crisis.²² Additionally, Part II states the primary purpose of the Rule, addresses one of the major concerns regarding the Rule, and gives a brief description of how the Rule was ultimately passed.²³ Part III addresses the unintended consequences of the Rule on banking entities.²⁴ First, it addresses hedge and private equity fund activities and shows how the legislation does not account for the underlying purpose of the Rule—reducing systemic risk.²⁵ Second, Part III examines the definition of proprietary trading to show the inherent difficulties in drafting a workable definition of proprietary trading, illustrating that an over-inclusive definition of proprietary trading may hurt

18. Aaron Lucchetti & Liz Rappaport, *Regulators, Banks Grapple with Volcker Rule's Reach*, WALL ST. J., Nov. 8, 2010, <http://online.wsj.com/article/SB10001424052748703727804575599430211025438.html>.

19. See Letter from Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs., to Members of Fin. Stability Oversight Council (Nov. 3, 2010), *available at* <http://op.bna.com/bar.nsf/r?Open=jtin-8avskw> [hereinafter Letter from Spencer Bachus].

20. *Implications*, *supra* note 15, at 10 (statement of Barry Zubrow, Executive Vice President and Chief Risk Officer at JPMorgan Chase).

21. See Gandel, *supra* note 7.

22. See *infra* Part II.A.

23. See *infra* Part II.B-C.

24. See *infra* Part III.A-D.

25. See *infra* Part III.A.

certain activities of banking entities that reduce systemic risk.²⁶ Third, Part III addresses the Rule's impact on the capital structure of banking entities.²⁷ Fourth, Part III addresses the potential competitive disadvantage to the U.S. financial system that the Rule creates.²⁸ Finally, Part IV addresses the implementation of the Rule²⁹ and addresses the recent Federal Reserve Board proposal relating to the conformance period for restricting these activities.³⁰

II. PURPOSE OF THE RULE AND ITS ENACTMENT

A. *The Financial Crisis*

Many proponents of the Rule believe that deregulation of the banking industry in 1999 was causally related to the financial crisis.³¹ However, lending, a core function of banks, was the most significant "proximate cause of the financial crisis."³² Banking entities reported nearly \$1.67 trillion in credit losses due to the financial crisis.³³ It is estimated that nearly eighty percent of the overall losses during the financial crisis were attributable to lending and securitization.³⁴ The Goldman Sachs Group, Inc. estimates that thirty-four percent of cumulative losses by banks were a result of direct real estate lending, that twenty percent of the losses incurred were a result of non real estate loans, and thirty-one percent of the losses incurred were a result of mortgage backed security holdings.³⁵ These lending and securitization

26. See *infra* Part III.B.

27. See *infra* Part III.C.

28. See *infra* Part III.D.

29. See *infra* Part IV.A.

30. See *infra* Part IV.B.

31. See Arjun Jayadev, *Financial Reform in the US: A Brief Overview*, ECON. & POL. WKLY., July 10, 2010.

32. *Implications*, *supra* note 15, at 5 (statement of Gerald Corrigan, Managing Director of Goldman Sachs Group, Inc.).

33. *Financial Stability: Hearing on 111 H.R. 4173 Before the S. Banking, Hous. and Urban Affairs Comm.*, 111th Cong. 4 (LEXIS) (2010) [hereinafter *Financial*] (statement of Hal S. Scott, Professor of International Financial Systems, Harvard Law School).

34. Hal S. Scott, *Suggestions for Regulatory Reform: The Reduction of Systemic Risk in the U.S. Financial System*, 33 HARV. J.L. & PUB. POL'Y 671, 676-77 (2010).

35. *Financial*, *supra* note 33, at 4 (statement of Hal S. Scott, Professor of

practices occurred not only at large national banks, but also at regional U.S. banks.³⁶ Furthermore, of the nearly \$1.67 trillion in credit losses some estimate that only thirty-three billion, or two percent of the losses were a result of trading and derivative activities at banks.³⁷ According to Senator Bob Corker of Tennessee, “‘not a single bank holding company’ involved in proprietary trading was among the companies that collapsed in 2008 and required a government bailout.”³⁸ Additionally, short-term proprietary trading traditionally has only had a nominal impact on bank profitability.³⁹ From such data, it can be inferred that proprietary trading and hedge and private equity fund activities did little to contribute to the financial crisis.⁴⁰ As a result, many opponents of the Rule have attacked its necessity and purpose.⁴¹

B. Primary Purpose of the Rule

The Rule’s primary purpose is to be a small piece of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), aimed at alleviating the need to bail out large banking entities that pose systemic risk to the financial health of

International Financial Systems, Harvard Law School) (discussing the losses incurred during the financial crisis).

36. *Id.*

36. *Id.*

37. *Id.*

38. Sewell Chan, *Dodd Calls Obama Plan Too Grand*, N.Y. TIMES, Feb. 3, 2010, at B1 (stating that a significant portion of the losses attributable to proprietary trading and hedge and private equity fund activities occurred in non-bank financial companies such as Lehman Brothers, Goldman Sachs, and Morgan Stanley).

39. Francesco Guerrera et al., *Wall Street to Sidestep ‘Volcker Rule,’* FIN. TIMES, Nov. 10, 2010, <http://www.ft.com/cms/s/0/3d49f12e-ed03-11df-9912-00144feab49a.html#axzz19c5lgmz9>.

40. See *Implications*, *supra* note 15, at 10-11 (statement of Barry Zubrow, Executive Vice President and Chief Risk Officer at JPMorgan Chase) (stating that it would be a “misunderstanding” to believe that these activities led to the financial crisis).

41. See *Prohibiting*, *supra* note 5, at 3 (statement of Sen. Christopher Dodd, Chairman of the S. Banking, Hous. and Urban Affairs Comm.) (acknowledging that many have objected to the Volcker Rule because they claim it would not have prevented the crisis, or on the grounds that it would have negative implications for the financial health of the United States).

the United States.⁴² It does so by limiting the amount of speculative, high-risk investments at banking entities.⁴³ Instead, it encourages banking entities to focus on client activities that are generally lower-risk.⁴⁴

The Rule, however, was met with staunch opposition for a number of reasons.⁴⁵ One of these reasons is the belief, by many, that the restricted activities are profitable for banking entities and very important to certain industries.⁴⁶ For example, bank investments into hedge and private equity funds are very important to these industries.⁴⁷ Historically, banks have been significant investors in private equity and have also represented a significant source of “direct proprietary involvement” in private equity funds.⁴⁸ Some believed that a complete ban on investments in private equity by banks would deal a potentially devastating

42. Although reducing systemic risk to banking institutions and the financial system is the primary goal of the Rule, it is also designed to address conflicts of interest and acknowledge the different cultures in hedge and private equity funds. For example, hedge and private equity funds rely heavily on their ability to innovate and trade freely, whereas banking regulation is in large part concerned with risk management and risk mitigation. *See id.* at 5-7 (statement of Paul Volcker, Chairman of the President’s Economic Recovery Advisory Board and Former Federal Reserve Chairman).

43. The key distinction between the types of investments permitted and those that are not is figuring out for whom the investments are made. *Id.* at 25 (statement of Neal S. Wolin, Deputy Secretary, Department of the Treasury).

44. Alerts, Matthew Dyckman et al., SNR Denton LLP, Financial Regulatory Reform—The Volcker Rule (Sept. 8, 2010), http://www.snrrenton.com/news__insights/alerts/the_volcker_rule.aspx [hereinafter Alerts].

45. *Prohibiting*, *supra* note 5, at 5, 7 (statement of Paul Volcker, Chairman of the President’s Economic Recovery Advisory Board and Former Federal Reserve Chairman) (noting that the key concern was how to define proprietary trading); *Financial*, *supra* note 25, at 5 (statement of Hal S. Scott, Professor of International Financial Systems, Harvard Law School) (noting that the restrictions on hedge and private equity fund activities could hurt these industries); *Infra* Part III.D (discussing the adverse effects the Rule could have on U.S. global competitiveness); *see also* Joe Adler & Donna Borak, *An Insider’s Take*, AM. BANKER, March 8, 2010, available at 2010 WLNR 4688533 (“The notion of a bunch of senators . . . trying to write in statute what proprietary trading is scares me.”).

46. *See* Jayadev, *supra* note 31.

47. *See Financial*, *supra* note 33, at 5-6 (statement of Hal S. Scott, Professor of International Financial Systems, Harvard Law School).

48. Banks and investment banks account for nearly twelve percent of the investments in private equity funds. Also, banks have raised nearly \$80 billion for such funds over the past five years. *Id.* at 5 (statement of Hal S. Scott, Professor of International Financial Systems at Harvard Law School).

blow to the already struggling private equity industry, while having a limited impact on reducing excessive risky behavior.⁴⁹ Restricting a significant capital source for these private equity funds will further diminish an already shrinking source of financing for American businesses.⁵⁰ Further, opponents of the Rule suggest that the benefits of allowing these investments clearly outweigh the potentially devastating effects that curtailing them may have on economic recovery.⁵¹ Hedge funds, for example, are very valuable to our financial markets.⁵² First, they provide liquidity to markets during times of stress.⁵³ Second, by pursuing arbitrage opportunities they help reduce or eliminate mispricing of financial assets.⁵⁴ And third, by taking short positions, they reduce the excessive enthusiasm of long-only investors.⁵⁵

C. *Compromise Leads to Enactment of a “Watered-down”
Volcker Rule*

After months of uncertainty, last minute negotiations to win “Republican support led to a compromise.”⁵⁶ Wielding enormous influence, newly elected Senator Scott Brown of Massachusetts took up the cause of large banks and financial institutions with significant operations in his state.⁵⁷ Brown argued

49. Despite this fact, the total amount of investment in private equity as of September 30, 2009 “accounted for less than three percent of the aggregate assets of the six largest banks.” *Id.* at 6 (statement of Hal S. Scott, Professor of International Financial Systems, Harvard Law School).

50. See Letter from Spencer Bachus, *supra* note 19.

51. Data shows that hedge fund holdings did not significantly reduce bank risk profiles. However, it is unclear how much hedge fund capital is derived from banking entities. See *Financial*, *supra* note 33, at 5-6 (statement of Hal S. Scott, Professor of International Financial Systems, Harvard Law School).

52. Alan Greenspan, Chairman, Risk Transfer and Financial Stability, Remarks at the Federal Reserve Bank of Chicago’s Forty-first Annual Conference on Bank Structure (May 5, 2005).

53. *Id.*

54. *Id.*

55. *Id.*

56. Yalman Onaran, *Volcker Said to Be Unhappy With New Version of Rule*, BLOOMBERG BUSINESSWEEK, June 30, 2010, at 1, available at <http://www.businessweek.com/news/2010-06-30/volcker-said-to-be-unhappy-with-new-version-of-rule.html>.

57. Democrats needed one vote to pass Dodd-Frank. Jia Lynn Yang, *Scott Brown’s Key Vote Gives Massachusetts Firms Clout in Financial Overhaul*,

that banks should be able to invest at least a small amount of capital into their own funds,⁵⁸ and Democrats needed his vote in order to pass the financial reform bill.⁵⁹ To garner his support, Congress passed a “watered down” version⁶⁰ of the Rule allowing certain de minimis investments in hedge and private equity funds.⁶¹

III. UNINTENDED CONSEQUENCES AND PROBLEMS WITH THE RULE

A. *The Rule’s Effect on Hedge and Private Equity Funds*

The Rule prohibits banking entities from “sponsoring”⁶² or holding an ownership interest in a hedge or private equity fund.⁶³ Banking entities include “any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)) [sic], any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity.”⁶⁴ These “general prohibitions” are subject to several exceptions.⁶⁵ Banking entities are allowed to organize and offer a hedge or private equity fund⁶⁶ if they meet a number of requirements.⁶⁷ Moreover, the

WASHINGTON POST, June, 23, 2010, at A12, available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/06/22/AR2010062205273.html>.

58. *Id.*

59. When asked how he felt about the compromise reached, Paul Volcker stated that “[s]hock is too strong a word . . . [b]ut I was disappointed.” John Cassidy, *The Volcker Rule: Obama’s Economic Advisor and His Battles Over the Financial-Reform Bill*, THE NEW YORKER, July 26, 2010, at 25.

60. Indiviglio, *supra* note 16 (stating that the revised version of the Rule passed was “watered down significantly from its original conception”).

61. See Cassidy, *supra* note 59.

62. A bank can sponsor a fund in three ways: (1) serving as a general partner, managing member or trust of a fund; (2) selecting or controlling a majority of the directors, trustees, or management of a fund; and (3) sharing the same name or variation of that name for business purposes. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13(h)(5), 124 Stat. 1376, 1630 (2010) (to be codified at 12 U.S.C. § 1851).

63. *Id.* sec. 619, § 13(a)(1).

64. *Id.* sec. 619, § 13(h)(1).

65. See *id.* sec. 619, §§ 13(d)(1)(G), 13(d)(4).

66. Organizing and offering a fund includes “serving as a general partner,

Rule allows banking entities to make a de minimis investment in funds if they do so for the purpose of “establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors; [] or making a de minimis investment.”⁶⁸ The banking entity after one year must only have a three percent ownership interest in such fund and the total aggregate investment of the banking entity in hedge and private equity funds may not exceed three percent of its Tier 1 capital.⁶⁹ Allowing these small infusions of capital will minimize the adverse effects on the hedge and private equity funds by helping new funds get off the ground.⁷⁰

managing member, or trustee of the fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees or management of the fund. *Id.* sec. 619, § 13(d)(1)(G).

67. A banking entity can organize and offer a hedge or private equity fund if: (1) “the banking entity provides bona fide trust, fiduciary, or investment advisory services;” (2) “the fund is organized and offered only in connection with the provision of bona fide trust, fiduciary, or investment advisory services and only to persons that are customers of such services of the banking entity;” (3) “the banking entity does not acquire or retain an equity interest, partnership interest, or other ownership interest in the funds except for a de minimis investment subject to and in compliance with paragraph (4);” (4) “the banking entity complies with the restrictions under paragraph (1) and (2) of subparagraph (f);” (5) “the banking entity does not . . . guarantee, assume, or otherwise insure obligations or performance of the hedge fund or private equity fund or of any hedge fund or private equity fund in which such hedge fund or private equity fund invests;” (6) “the banking entity does not share with the hedge fund or private equity fund . . . the same name or a variation of the same name;” (7) “no director or employee of the banking entity takes or retains an equity interest, partnership interest, or other ownership interest in the hedge fund or private equity fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the hedge fund or private equity fund;” and (8) “the banking entity discloses to prospective and actual investors in the fund, in writing, that any losses in such hedge fund or private equity fund are borne solely by the investors and not by the banking entity” Dodd-Frank Act, sec. 619, § 13(d)(1)(G) (to be codified at 12 U.S.C. § 1851).

68. A banking entity that makes such an investment must seek investors unaffiliated with the banking entity to reduce the banks investment. After one year, the amount of ownership in any such fund may not exceed three percent, and the aggregate ownership interest in all such funds may not exceed three percent of the Tier 1 capital of the bank. *Id.* sec. 619, § 13(d)(4).

69. *Id.* sec. 619, § 13(d)(4)(B)(ii).

70. Allowing this “seed money” will provide a source of initial capital for new funds. See *Financial*, *supra* note 33, at 6 (statement of Hal S. Scott, Professor of International Financial Systems at Harvard Law School).

The de minimis exception, however, may provide a benefit for some banking entities.⁷¹ The three percent investment limitation in any hedge or private equity fund will give banking entities the excuse to limit the amount of capital they invest in each fund—called putting “skin in the game.”⁷² Banks put “skin in the game” in order to convince clients that the fund is a good investment.⁷³ Now, banks will be able to “stop the arms race” at three percent, and customers will not be able to demand a larger commitment.⁷⁴

However, reducing the amount of capital banks can legally put into hedge and private equity funds will hurt these funds, especially funds that rely extensively on their significant connections with banking entities.⁷⁵ One reason that investors favor these funds is due to the fact that banks put significant capital into these funds.⁷⁶ These funds rely not only on the bank’s capital, but also on the network that the bank provides for them.⁷⁷ In-house funds may inevitably see their “investment thesis” change dramatically because outside investors may be unwilling to invest in these funds without the significant commitment from banks and the network that they provide.⁷⁸ In turn, success of these funds may be irreparably damaged.⁷⁹ Thus, the Rule takes away a significant type of investor for hedge and private equity funds, and for funds that rely in large part on banking entities, the Rule may be a death sentence.⁸⁰

Another major concern relating to the restrictions on hedge and private equity fund activities is the definition of such funds.⁸¹

71. Carney, *supra* note 16; Indiviglio, *supra* note 16.

72. See Carney, *supra* note 16.

73. See *id.*

74. Previously, banks had been forced to commit more and more funds to the hedge funds to compete with other funds. Indiviglio, *supra* note 16.

75. See Nicholas Donato & Toby Mitchennall, *Regulation Gold Rush?*, PRIVATEEQUITYONLINE.COM, Sept. 6, 2010.

76. *Id.*

77. See *id.*

78. See *id.*

79. See *Id.*

80. Cf. *id.* (stating that the “investment thesis of the[se] [have] radically changed,” if the bank decides to spin off its commitment in in-house funds).

81. Malini Manickavasagam, *Regulatory Reform: SIMFA Warns of Legal Uncertainty in Volcker Rule’s Fund Restrictions*, BNA BANKING REP., Nov. 16, 2010.

Uncertainty has ensued due to congressional reliance on definitions in the 1940 Investment Company Act (Act).⁸² Under the Rule, funds that are not required to register under the Act pursuant to section 3(c)(1) or 3(c)(7) are considered hedge or private equity funds.⁸³ However, there are investments vehicles and corporate structures that rely on such exclusions that are not hedge or private equity funds and share little, if any, characteristics with these types of funds.⁸⁴ Relying on this broad definition could go beyond the scope of the intended target of the Rule—hedge and private equity funds.⁸⁵ As a result, the American Bankers Association proposed that the Financial Stability Oversight Council identify the inherent characteristics of hedge and private equity funds and remove companies that do not exhibit these characteristics from the ambit of the Rule.⁸⁶

For example, Canadian banks operating in the United States have expressed concern that Canadian Public Funds that are not registered under the Act may be subject to the restrictions.⁸⁷ These banks are subject to the Rule's restrictions because they operate in the United States.⁸⁸ A literal reading of the Rule would

82. Letter from Lisa J. Bleier, Vice President and Senior Counsel, Am. Bankers Ass'n to Alastair Fitzpayne, Deputy Chief of Staff and Executive Sec'y, Dep't of Treasury (Nov. 3, 2010) [hereinafter Letter from Lisa J. Bleier] (on file at www.regulations.gov). The Securities Industry and Financial Markets Association as well as the Private Equity Growth Capital Council and Managed Funds Association have voiced concerns over which funds would be considered hedge and private equity funds. Manickavasagam, *supra* note 81.

83. Letter from Lisa J. Bleier, *supra* note 82.

84. For example, "[e]ntities that are commonly utilized by banking entities to facilitate permissible activities include acquisition vehicles or joint ventures relating to a single underlying investment, finance subsidiaries, credit funds, employee pension funds, bank-owned life insurance policies, [and] foreign funds regulated under the laws of other countries" would be considered hedge or private equity funds. *Id.*

85. *Id.*; see also Manickavasagam, *supra* note 81 (stating that Representative Frank believes that the definition of hedge and private equity funds should not be "overdone" and that they do not want there to be excessive regulation).

86. Letter from Lisa J. Bleier, *supra* note 82.

87. Letter from Barbara Muir, Vice-President & Deputy Gen. Counsel, Bank of Montreal, to the Fin. Stability Oversight Council (Nov. 5, 2010) [hereinafter Letter from Barbara Muir] (on file at www.regulations.gov).

88. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13(h)(1), 124 Stat. 1376, 1629 (2010) (to be codified at 12 U.S.C. § 1851). Banking entities include "any non-US bank (and any parent company) that has a US branch, agency, commercial lending company or insured

impose restrictions “extraterritorially’ on Canada and other foreign jurisdictions” even though they have local statutes comparable to the Act, while U.S. Public Funds are registered under the Act and thus are not treated as hedge or private equity funds.⁸⁹ Regulating these public funds is not supported by the goals of the Rule.⁹⁰ The majority of the investors in such funds are Canadian citizens, and as a result, these funds “have little impact on the U.S. financial markets.”⁹¹ Treating such funds as hedge and private equity funds would require these foreign banks to divest their ownership interests in funds organized and regulated by the laws of their country, even though they have little impact on the financial health of the United States.⁹² Due to this illogical result, foreign banks expressed their concerns regarding the Rule and proposed that regulations need to exempt such public foreign funds from the definition of hedge and private equity funds.⁹³

The venture capital industry has voiced similar concerns.⁹⁴ Venture capital firms serve many important functions to the U.S. economy: they promote technological innovation, create high quality jobs, and promote economic growth in vitally important industries.⁹⁵ Additionally, banks that do invest in these funds

depository institution subsidiary.” MAYER BROWN LLP, UNDERSTANDING THE NEW FINANCIAL REFORM LEGISLATION: THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 64 (2010), http://www.mayerbrown.com/dodd_frank_act/article.asp?id=9360&nid=13007.

89. Letter from Barbara Muir, *supra* note 87.

90. *Cf. Prohibiting*, *supra* note 5, at 8 (statement of Paul Volcker, Chairman of the President’s Economic Recovery Advisory Board and Former Federal Reserve Chairman) (stating that in order to address the underlying causes of the financial crisis the Volcker Rule addresses a number of factors that includes reducing the ability of banking entities that engage in risky activities to use social mechanisms such as FDIC insurance).

91. Letter from Barbara Muir, *supra* note 87 (stating also that U.S. affiliates of Canadian banks do not have exposure to Canadian funds and also that Canadian funds cannot assert claims for federal subsidies such as FDIC insurance in the United States).

92. *Id.*

93. *See id.*

94. Letter from Mark G. Heesen, President, National Venture Capital Ass’n, to Fin. Stability Oversight Council (Nov. 2, 2010) [hereinafter Letter from Mark G. Heesen] (on file at www.regulations.gov).

95. *Id.* (stating that the venture capital industry promotes economic growth in industries such as software, biotechnology, medical devices and clean technology, and these companies account for twelve million jobs and twenty-one percent of U.S. GDP).

provide meaningful benefits to their clients and to the sector, and the banks that do so are already subject to regulatory exams to make sure these activities do not present risks to the insured depository institution.⁹⁶ These investments, however, usually do not create “systemic risk” to banking entities or the financial system and do not cause the harms the Rule is intended to address.⁹⁷ Because these investments do not pose “safety and soundness concerns,” the industry urges that the regulatory agencies either exempt these funds from the definition of hedge and private equity funds or use their discretion to treat these activities as those that “promote and protect the financial stability of our country,” pursuant to section 619(d)(1)(J).⁹⁸ A failure to exempt these funds will decrease capital to a vitally important industry resulting in undesirable consequences that will hurt the financial health and competitiveness of the United States.⁹⁹

B. Problems with Definition of Proprietary Trading

A literal reading of the Rule may lead one to come to the conclusion that the definition of proprietary trading is “watertight.”¹⁰⁰ Proprietary trading is defined as

engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the [Federal Reserve] Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, derivative, any contract of sale of a commodity for future delivery, any

96. *Id.*

97. Senator Chris Dodd made remarks on the senate floor that venture capital investments do not present the same types of harm that the Rule is intended to curb. Letter from E. William Parsley III, Treasurer and Chief Inv. Officer, The PNC Fin. Servs. Group, to the Fin. Stability Oversight Council (Nov. 5, 2010) [hereinafter Letter from E. William Parsley III] (on file at www.regulations.gov).

98. Letter from Mark G. Heesen, *supra* note 94.

99. Countries worldwide are already attempting to draw in capital and talent from this industry in the U.S. “Artificially” restricting capital flows into this small but critical industry is not the best way to address this problem. *See id.*

100. Antony Currie, *Volcker Rule Won't so Quickly Squelch House Bets*, REUTERS BLOG, (Aug. 5, 2010, 3:00 PM), <http://blogs.reuters.com/columns/2010/08/05/volcker-rule-wont-so-quickly-squelch-house-bets>.

option on any such security, derivative, or contract, or any security or financial instrument that the appropriate Federal banking agencies, the [SEC], and the Commodity and Futures Trading commission may, by rule as provided in section (b)(2), determine.¹⁰¹

The term trading account is defined as

any account used for acquiring or taking positions in securities or instruments . . . principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided . . . determine.¹⁰²

However, when one analyzes these two statutory definitions of proprietary trading in tandem, it is clear that proprietary trading may be difficult to pinpoint.¹⁰³ According to the legislation, proprietary trading only accounts for trading in the “near term” or trades that involve “short-term price movement.”¹⁰⁴ Determining what constitutes a trade in the “near term,” even if strictly defined by regulation, may prove to be futile.¹⁰⁵ Although Paul Volcker stated that every banker knows what proprietary trading is, there is a certain amount of gray area, and even if regulators are able to define trading in the near term as holding on

101. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13(h)(4), 124 Stat. 1376, 1630 (2010) (to be codified at 12 U.S.C. § 1851).

102. *Id.* sec. 619, § 13(h)(6).

103. Memorandum by Brian D. Christensen & William J. Sweet Jr., Skadden, Arps, Slate, Meagher & Flom LLP, *The Volcker Rule* (July 9, 2010), <http://www.skadden.com/Index.cfm?contentID=51&itemID=2128>.

104. *Id.*

105. See Antony Currie & Christopher Swann, *The Uncertainties of the Volcker Rule*, N.Y. TIMES, Aug. 5, 2010, at B2, available at <http://www.nytimes.com/2010/08/06/business/06views.html>.

to a security for less than two weeks, traders will be able to find new and inventive ways around such restrictions.¹⁰⁶ For instance, bankers may be able to create a financial swap that offsets the time restriction, allowing the bank to buy back the security at a future date.¹⁰⁷ In the meantime, however, there is a lot of uncertainty about which trades will be covered and which will not.¹⁰⁸ Due to this uncertainty, the success of the Rule will rely heavily on regulators.¹⁰⁹

This vague language may also allow banks to make minimal adjustments to their proprietary trading groups in order to comply with the Rule.¹¹⁰ They can do this in one of two ways: (1) by altering the timing of trades; or (2) by altering the participant in the trade.¹¹¹ First, they may be able to continue to engage in proprietary trading by making the trades on an agency basis, by buying and selling securities for their customers and not for their own account.¹¹² Alternatively, “by extending the time frame of the trade” a bank may be able to engage in current trading activities on a principal basis, by directly trading for the bank.¹¹³ These “principal investments,” which are characterized by longer-term commitments and higher capital charges, were important to banks’ profits during the financial crisis but were also responsible for large losses.¹¹⁴ Banking entities, nevertheless, plan to continue such investments.¹¹⁵ Neither of these potential loopholes exemplifies the “hard legislative proscription” that Volcker

106. Interview by Erik Schatzker with Robert Wosnitzer, Professor at New York University, BLOOMBERG TV (Nov. 9, 2010).

107. *Id.*

108. See Currie & Swann, *supra* note 105.

109. See Cassidy, *supra* note 59.

110. Alerts, *supra* note 44.

111. *Id.*

112. *Id.*; see also Dodd-Frank Wall Street and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13(d)(1)(D), 124 Stat. 1376, 1624 (2010) (to be codified at 12 U.S.C. § 1851) (stating that trading transactions on behalf of customers are explicitly allowed).

113. Alerts, *supra* note 44.

114. Guerrero et al., *supra* note 39.

115. *Id.* (stating that Goldman Sachs, JPMorgan Chase and Morgan Stanley plan to continue making direct investments).

envisioned, and both would allow banks to engage in alleged speculative activity.¹¹⁶

Furthermore, the Rule allows banking entities to engage in a number of permitted activities, two of which are “market making” and “risk mitigated hedging.”¹¹⁷ These permitted activities are considered vital to banking entities¹¹⁸ but are often hard to differentiate from proprietary trading.¹¹⁹ For instance, it will be difficult for regulators to distinguish between market making and proprietary trading.¹²⁰ According to the SEC, market makers are “firm[s] that stand ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price.”¹²¹ Market making is a requisite activity of “well-managed and well-supervised bank[s].”¹²² Banking entities engage in market making for two reasons: to provide market liquidity and to facilitate trading in certain securities.¹²³ Proponents of the Rule believe that it will be challenging to differentiate between the two activities, but it is possible.¹²⁴ On the other hand, opponents believe that it is an impossible task.¹²⁵ The task of delving into this

116. See *Prohibiting*, *supra* note 5, at 15-16 (statement of Paul Volcker, Chairman of the President’s Economic Recovery Advisory Board and Former Federal Reserve Chairman) (stating that the new rule should have legislative proscriptions rather than a loose voluntary provision); Guerrero et al., *supra* note 31 (“Simon Johnson, professor at [MIT], said it would be ‘pretty crazy’ if banks were allowed to invest as a principal in longer-maturing assets and securities. ‘That’s exactly how banks blew themselves up.’”).

117. The Rule also allows trading activities in government securities, on behalf of customers, by an insurance business on behalf of the insurance company, investments in small business investment companies, the public welfare, and qualified rehabilitation expenditures, and any additional activities that the Regulators determine promote the safety and soundness of the U.S. financial stability. Dodd-Frank Act, sec. 619, § 13(d)(1) (to be codified at 12 U.S.C § 1851).

118. Letter from E. William Parsley III, *supra* note 97.

119. Mike Ferullo, *Drawing a Line Between Proprietary Trading, Market Making a Challenge for Regulators*, BNA BANKING REPORT, Nov. 30, 2010.

120. See Memorandum from Thomas M. Hoenig, President of the Fed. Reserve Bank of Kansas City, Comments on the Volcker Rule Activity Restrictions (Mar. 2, 2010) [hereinafter Memorandum from Thomas H. Hoenig] (on file with the Kansas City Federal Reserve).

121. *Market Maker*, SEC. AND EXCH. COMM. (Mar. 17, 2000), <http://www.sec.gov/answers/mktmaker.htm>.

122. *Implications*, *supra* note 15, at 5 (statement of Gerald Corrigan, Managing Director of Goldman Sachs).

123. Ferullo, *supra* note 119.

124. See *id.*

125. Hal S. Scott, Professor of International Financial Systems at Harvard Law

“gray area” is left to the applicable regulatory agencies,¹²⁶ and an improper definition of market making or proprietary trading could reduce the safety and soundness of banking institutions and restrict the availability and cost of credit.¹²⁷

These regulatory agencies face challenges due to the similarities between the two activities.¹²⁸ First, market making may encompass trading in the “near term”¹²⁹ as does the prohibition in the Rule.¹³⁰ Second, banking entities have used the same trading desk for both types of activities.¹³¹ Third, banking entities profit from both market making activities and proprietary trading, and banking entities also use their own capital to fund such operations.¹³² Further, some speculators sometimes have customers, making them look like market makers, and market makers sometimes become speculators.¹³³ On the other hand, market making does not contain the element of “trading as a principal” for the bank or banking entity.¹³⁴ Although this seems

School, stated that he does not believe it is possible to differentiate between proprietary trading and market making. “[He] thinks that we have to give people lie detectors or something.” *Id.* Even regulators believe that it is not easy to tell the difference and some instruments may be of “dual purpose.” R. Christian Bruce, *GOP-Controlled House May Shape Rulewriting Under Dodd-Frank Act*, BNA BANKING REPORT, Nov. 9, 2010 [hereinafter Bruce, *GOP*].

126. See Ferullo, *supra* note 119.

127. *Implications*, *supra* note 15, at 11-12 (statement of Barry Zubrow, Executive Vice President and Chief Risk Officer at JPMorgan Chase).

128. See Ferullo, *supra* note 119.

129. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13(h)(6), 124 Stat. 1376, 1630 (2010) (to be codified at 12 U.S.C § 1851).

130. Compare Dodd-Frank Act, sec. 619, § 13(h)(4) (to be codified at 12 U.S.C § 1851) (stating that proprietary trading is trading is “engaging as a principal for the trading account of a banking entity”), and *id.* sec. 619, § 13(h)(6) (“The term ‘trading account’ means any account used for acquiring or taking positions securities and instruments described in paragraph (4) principally for the purpose of selling in the near term”), with *Market Maker*, *supra* note 121 (stating that market makers stand ready to buy and sell a particular stock on a regular and continuous basis).

131. Ferullo, *supra* note 119.

132. See William L. Silber, *On the Nature of Trading: Do Speculators Leave Footprints?*, 29 J. PORTFOLIO MGMT. 64, 65 (2003).

133. *Id.* at 64.

134. Compare Dodd-Frank Act, sec. 619, § 13(h)(4) (to be codified at 12 U.S.C § 1851) (stating that proprietary trading is “engaging as principal for the trading account of a banking entity”), with *Market Maker*, *supra* note 121 (“A ‘market maker’ is a firm that stands ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price.”).

straightforward, it is actually very difficult to tell if a bank is trading for its own purposes or for its customers, and many skeptics of the Rule were wary of such a definition.¹³⁵ Senator Jeff Merkley and Senator Carl Levin suggest that regulations seeking to distinguish between the two will “require routine data from banks on the volume of trading being conducted, the size of accumulated positions, the length of time positions remain open, average bid-ask spreads, and the volatility of profits and loss”¹³⁶ However, determinations based on quantitative data may result in an arbitrary cut-off line between legitimate market making and proprietary trading.¹³⁷ There is further difficulty because the timing of market making positions could vary greatly depending on the type of financial instrument and market conditions.¹³⁸ As a result, such line drawing may be overly broad, including legitimate market making activities that banks have engaged in for many years, or on the other hand, under-inclusive, whereby it does not include the type of trading the Rule sought to ban.¹³⁹ This difficulty may allow banks to hide their proprietary trading by making these trading activities resemble market making.¹⁴⁰ On the other hand, an attempt to limit banking entities’ ability to hide proprietary trading in these activities may severely

135. *Implications*, *supra* note 15, at 12 (statement of Sen. Christopher Dodd, Chairman of the S. Banking, Hous. and Urban Affairs Comm.) (stating that an individual in the banking industry told him that “[he] can find a way to say that virtually any trade we make is somehow related to serving one of our clients. They can go ahead and impose the rule on Friday and I can assure you that by Monday we’ll find a way around it.”).

136. See Memorandum from Scott Cammarn et al., Cadwalader, Wickersham & Taft LLP, An Analysis of the Dodd-Frank Act’s Volcker Rule, to Clients & Friends 7 (Oct. 15, 2010), http://www.cadwalader.com/search_results.php?search=volcker+rule [hereinafter Memorandum from Scott Cammarn] (quoting the two Senators in an August 3rd letter to the banking agency head). They also propose in their comments to the Financial Stability Oversight Council that regulators should key in on timings of the trades since focusing on the intent of traders can be time consuming and subjective. Letter from Sen. Merkley et al., to the Fin. Stability Oversight Council (Nov. 4, 2010) (on file at www.regulations.gov).

137. See Memorandum from Scott Cammarn, *supra* note 136, at 7.

138. See Letter from Carolyn Walsh, Deputy Gen. Counsel, ABA Sec. Ass’n, to Alistair Fitzpayne, Deputy Chief of Staff & Exec. Sec’y, Dep’t of the Treasury (Nov. 4, 2010) [hereinafter Letter from Carolyn Walsh] (on file at www.regulations.gov).

139. See *id.*

140. Memorandum from Thomas H. Hoenig, *supra* note 120.

limit their ability to serve customers and facilitate markets, hurting the financial health of the United States.¹⁴¹

Concerns have also been raised as to what will constitute “risk mitigating hedging activities.”¹⁴² Exclusion of these activities is critical to banking entities since they allow them to effectively manage risk.¹⁴³ To mitigate risks, banking entities often take derivative positions.¹⁴⁴ Proponents of a strong Rule suggest that banking entities must be prohibited from buying a “variant” of the same derivative from another financial firm in an effort to hedge some of their risky financial derivatives.¹⁴⁵ Even though these comments have their merits, regulators must also take into account the fact that each banking entity’s business model and risk exposure is different.¹⁴⁶ Further, trades that are looked at in “isolation” may resemble proprietary trading; however, the trade may be “part of a mosaic of serving clients and properly managing the firm’s risks.”¹⁴⁷ Although delineating a line between permitted hedging activities and speculative activities will be very difficult to do, an overreaching Rule that restricts activities that are important to banks may increase systemic risk by hurting the ability of banking entities to manage risks on their balance sheets.¹⁴⁸

141. Cf. Letter from Carolyn Walsh, *supra* note 129 (stating that there should be a process whereby the Federal Reserve is able to exempt certain activities so they can promptly address any unintended application of the Rule, which could affect the “orderly functioning of the markets”).

142. See Letter from E. William Parsley III, *supra* note 97; Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds, 75 Fed. Reg. 61,758, 61,759 (Oct. 6, 2010) [hereinafter Public Input] (requesting comments concerning “risk mitigating hedging activities”).

143. See Letter from E. William Parsley III, *supra* note 97.

144. Cf. *id.* (stating that banks take risks in everything they do).

145. Letter from Lynn A. Stout, Paul Hastings Professor of Corporate and Securities Law, UCLA School of Law, to Members of the Financial Stability Oversight Council (Nov. 4, 2010) [hereinafter Letter from Lynn A. Stout] (on file at www.regulations.gov).

146. See Letter from E. William Parsley III, *supra* note 97.

147. *Implications*, *supra* note 15, at 11 (statement of Barry Zubrow, Executive Vice President and Chief Risk Officer at JPMorgan Chase).

148. Letter from E. William Parsley III, *supra* note 97; see also *Implications*, *supra* note 15, at 12 (statement of Sen. Christopher Dodd, Chairman of the S. Banking, Hous. and Urban Affairs Comm.) (“While numerical limits and strict rules may sound simple, there is great potential that they would undermine the goals of economic stability, growth and job creation.”).

C. *Impact on Capital Structure of Banking Entities*

Most large banks will be able to comply with the proprietary trading restriction without making significant changes to their capital structures.¹⁴⁹ For most banking entities, the amount of proprietary trading “is too negligible” to significantly affect them.¹⁵⁰ Nevertheless, firms such as Citigroup,¹⁵¹ Goldman Sachs, and JPMorgan Chase have already shed some of their proprietary trading groups.¹⁵² The Rule will likely only drastically affect Goldman Sachs, which derives ten percent of its revenues from proprietary trading.¹⁵³ Proprietary trading, however, may be a source of diversification, mitigating risk rather than increasing it.¹⁵⁴ Firms that had significant trading operations fared better than those that had highly concentrated exposure to certain assets.¹⁵⁵ Because the Rule will only have a nominal impact on banking entities’ capital structure, but may result in less diversification and increased risk, the benefits of allowing such activities may outweigh the nominal gains from constricting these activities.¹⁵⁶

Additionally, most banking entities will have plenty of time to comply and will be able to gradually spin off their hedge and private equity funds that do not comply with the Rule.¹⁵⁷ In fact, most banks could very well hold onto their in-house hedge and private equity funds.¹⁵⁸ Some individuals in the financial industry believe that some firms will do more trading in-house, rather than

149. See Carney, *supra* note 16.

150. *Financial*, *supra* note 33, at 4 (2010) (statement of Hal S. Scott, Professor of International Financial Systems, Harvard Law School).

151. See Megan Davies & Svea Herbst-Bayliss, *Volcker Impact Sends Shivers Through Banks*, REUTERS, Aug. 9, 2010, available at <http://www.reuters.com/article/idUSLNE67800N20100809>.

152. See Letter from Spencer Bachus, *supra* note 19.

153. See Indiviglio, *supra* note 16.

154. *Financial*, *supra* note 33, at 5 (statement of Hal S. Scott, Professor of International Financial Systems, Harvard Law School).

155. Goldman Sachs, Morgan Stanley and JP Morgan all had significant trading operations and survived the financial crisis. On the other hand, firms with concentrated exposures in real estate such as Lehman Brother failed. *Id.*

156. See *id.*

157. See Carney, *supra* note 16; Donato & Mitchenhall, *supra* note 75 (stating that most banks may not have to fully comply with the rules for 10-12 years).

158. Banks would be able to do this but would need to hold smaller shares in the private equity group. See Cassidy, *supra* note 59.

investing in established hedge and private equity funds that would be open to outside investors.¹⁵⁹ If true, this practice would make risk “less diversified and more concentrated,” which in effect would increase the risk profiles of these banks and their vulnerability to shocks in the financial system.¹⁶⁰ However, banks must seek “unaffiliated investors”¹⁶¹ to these funds, and this provision ameliorates the concern that these funds would not be open to outside investors.¹⁶²

D. *Global Competitiveness*

During congressional hearings, supporters and critics alike voiced concerns that enacting the provisions of the Rule unilaterally would hurt U.S. competitiveness.¹⁶³ To date, the restricted activities are permitted everywhere else in the world.¹⁶⁴ This “go it alone” approach was not the outcome desired by Paul Volcker and supporters of the Rule.¹⁶⁵ An inflexible implementation of the Rule could result in “regulatory arbitrage,”¹⁶⁶ pushing customer activity to non-regulated entities in

159. See Indiviglio, *supra* note 16.

160. See *id.*

161. Unaffiliated investor is an undefined term and will need further rulemaking to determine who constitutes an unaffiliated investor. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13(d)(4)(B)(i), 124 Stat. 1376, 1627 (2010) (to be codified at 12 U.S.C § 1851).

162. See *id.* sec. 619, § 13(d)(1)(G).

163. See *Prohibiting*, *supra* note 5, at 11 (statement of Paul Volcker, Chairman of the President’s Economic Recovery Advisory Board and Former Federal Reserve Chairman) (stating that the U.S. could go it alone, but it is not the “desired outcome”). Representative Bachus originally put forth a proposal conditioning the acceptance of the Rule on condition that the majority of the G-20 countries implemented it. Letter from Spencer Bachus, *supra* note 19.

164. Letter from Spencer Bachus, *supra* note 19 (stating that EU countries have rejected the Rule and have no plans to adopt it); see also Andrew Clark, *Myners: UK Does Not Need to Copy Obama Banking Reforms*, GUARDIAN (Jan. 22, 2010, 2:51 PM), <http://www.guardian.co.uk/politics/2010/jan/22/uk-considers-barack-obama-style-banking-reform/print> (stating that the UK does not intend to copy the Volcker Rule legislation).

165. See *Prohibiting*, *supra* note 5, at 11 (statement of Paul Volcker, Chairman of the President’s Economic Recovery Advisory Board and Former Federal Reserve Chairman); *Id.* at 31 (statement of Neal S. Wolin, Deputy Secretary, Department of Treasury) (“I think we are working closely with our G-20 partners to make sure that we get a regime that works worldwide so that we don’t have new opportunities for arbitrage.”).

166. See Chris Skinner, *How the Dodd-Frank Legislation Impacts Capital Markets*,

the United States or to foreign financial companies not subject to U.S. regulation.¹⁶⁷ The major concern is that making U.S. firms divest these business activities could result in capital and talent flowing overseas to foreign firms not regulated by the Rule.¹⁶⁸ Another potential consequence of the Rule is that it could restrict U.S. banking entities' ability to manage risk and diversify their portfolios since trading and fee income derived from a diverse set of financial products and services can make banking entities less risky and more stable.¹⁶⁹ As a result, U.S. banking entities in comparison to their foreign counterparts may be significantly limited in their ability to manage risks.¹⁷⁰ If federal regulators do not take into account these negative consequences, the competitive disadvantage to the U.S. financial system may eviscerate any gains from restricting these activities.¹⁷¹

IV. IMPLEMENTATION OF THE RULE

A. *Rulemaking and Implementation*

Despite significant uncertainty, banking regulators are dealt the daunting task of determining the ultimate effect of the Rule on banking entities.¹⁷² On October 6, 2010, the Financial Stability Oversight Council (the FSOC) sent out a request for information on the Rule.¹⁷³ Comments to the Rule obtained by

FIN. SERVICES CLUB BLOG (Aug. 2, 2010, 8:30 AM), <http://thefinanser.co.uk/fsclub/2010/08/how-the-doddfrank-legislation-impacts-capital-markets.html> (defining regulatory arbitrage as instances where a restrictive business environment may cause firms to move activities to less restrictive markets).

167. Manickavasagam, *supra* note 81; Letter from E. William Parsley III, *supra* note 97.

168. Firms such as Goldman Sachs and J.P. Morgan have already shed their prop trading units. Letter from Spencer Bachus, *supra* note 19.

169. *Id.*

170. *Id.*

171. *See id.* (recommending that the FSOC study of the Rule "take account of how trading activities fit into the global core business plan of banks, as well as the consequences for U.S. banks and banks' clients of prohibiting [these] activities in the U.S. while they continue to be permitted everywhere else in the world").

172. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13(b), 124 Stat. 1376, 1621-22 (2010) (to be codified at 12 U.S.C. § 1851).

173. Public Input, *supra* note 142, at 61,758.

this information request will guide the FSOC study submitted on January 21, 2011.¹⁷⁴ The federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission are required to consider these findings when promulgating regulations carrying out the Rule.¹⁷⁵

During the comment process (which ended on November 5, 2010),¹⁷⁶ proponents and critics of the Rule voiced their concerns relating to the Rule's implementation.¹⁷⁷ The major concerns relate to market making and legitimate hedging activities and how they will be defined, the definition of hedge and private equity funds, and the effect the Rule will have on U.S. competitiveness.¹⁷⁸ Some proponents of the Rule believe that the regulatory agencies should implement a strong Rule, focusing on the intent of Congress.¹⁷⁹ Supporters of the Rule, however, understand that implementation of the Rule needs to avoid "unintended and undesirable consequences."¹⁸⁰ Even though the goals of the Rule are desirable,¹⁸¹ strong implementation of the Rule that does not account for unintended consequences will likely have the opposite effect, increasing risk to the U.S. financial system.¹⁸²

174. FSOC is required to submit a study and make recommendations on the implementations of the Rule no later than six months after enactment (Dodd-Frank was enacted on June 21, 2010). Dodd-Frank Act, sec. 619, § 13(b)(1), (to be codified at 12 U.S.C § 1851).

175. *Id.* sec. 619, § 13(b)(2).

176. Public Input, *supra* note 142, at 61,758.

177. *Compare* Letter from Paul A. Volcker, *supra* note 14 (stating that implementation of the Rule should focus on the intent of the Rule and should be a strong prohibition against the restricted activities), *with* Letter from Spencer Bachus, *supra* note 19 (stating that the Rule has many unintended consequences and may hurt U.S. banking entities competitiveness internationally).

178. *See* discussion *supra* Parts III.A-C.

179. *E.g.*, Letter from Michael Greenberg, Professor, University of Md. School of Law, to Timothy Geithner, Chairman of Fin. Stability Oversight Council (Nov. 5, 2010) (on file at www.regulations.gov); *see also* Letter from S. Merkley et al., to Members of Fin. Stability Oversight Council (Oct. 28, 2010) (on file at www.regulations.gov) (recommending a two-tiered, cooperative regulatory structure, whereby regulators conduct real-time monitoring and enforcement and regulators review firms' policies and procedures and conduct in-depth portfolio examinations).

180. *See* Letter from E. William Parsley III, *supra* note 97.

181. *See* Letter from Lynn A. Stout, *supra* note 145 (stating that the goals of the Rule are reducing systemic risk in the U.S. financial system by reducing risky activities in banking entities).

182. *See* Letter from Spencer Bachus, *supra* note 19.

B. Conformance with the Rule and the Fed's Proposed Rule

The Rule allows banking entities two years to comply with the restrictions after the prohibitions take effect, which is the earlier of July 21, 2012, or twelve months after issuance of the final regulations.¹⁸³ The Federal Reserve Board (the Fed) is granted authority to extend this two-year period for one year at a time if, in its judgment, the extension is “consistent with the purposes of this section and would not be detrimental to the public interest.”¹⁸⁴ Any banking entity meeting the guidelines of the Fed is eligible for up to three one-year extensions.¹⁸⁵ The conformance period is intended to avoid market disruption and give banking entities time to adjust to the provisions of the Rule.¹⁸⁶

The Fed's proposed rule implements the provisions of the Rule granting banking entities two years to comply with Rule's restrictions once it takes effect, but a banking entity can request additional extensions.¹⁸⁷ Under the proposed rule, a banking entity that seeks an extension must submit a request to the Board.¹⁸⁸ In making its determination, the Fed will consider, among other things,¹⁸⁹ market conditions, “the nature of the trading activit[ies] or investment[s],” the level of risk, and whether the investment involves “material conflicts between the banking entity and its

183. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13(c)(1) 124 Stat. 1376, 1622 (2010) (to be codified at 12 U.S.C. § 1851). All of these permitted activities, however, are not allowed if they result in “material conflicts of interest,” expose the bank to high-risk assets or trading strategies, pose a threat to “safety and soundness” of the bank, or threaten the financial stability of the U.S. *See id.* sec. 619, § 13(d)(2).

184. The Fed is granted sole authority to make Rules determining the conformance period. *Id.* sec. 619, § 13(c)(2).

185. *Id.*

186. Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity or Hedge Fund Activities, 75 Fed. Reg. 72,741, 72,742 (proposed Nov. 26, 2010) [hereinafter Conformance] (to be codified at 12 C.F.R. pt. 225).

187. *Id.* at 72,743.

188. *Id.* (“Any such request for an extension must: (1) Be submitted in writing to the Board at least 90 days prior to the expiration of the applicable time period; (2) provide the reasons why the banking entity believes the extension should be granted; and (3) provide a detailed explanation of the banking entity's plan for divesting or conforming the activity or investment(s).”).

189. *Id.* (“These factors are not exclusive, and under the proposal, the Board retains the ability to consider other factors or considerations that it deems appropriate.”).

customer or counterparties.”¹⁹⁰ Also, under the proposed rule, the Fed may impose additional conditions on any extensions “if the Board determines such conditions are necessary or appropriate to protect the safety and soundness of banking entities or the financial stability of the United States, address material conflicts of interest or other unsound practices, or otherwise further the purposes of section 13 of the BHC Act and the other proposed Rules.”¹⁹¹ It further provides that if a nonbank financial company becomes a banking entity after July 21, 2010, then the resulting banking entity must come into compliance with the restrictions of the Rule at the later of: (1) the date the prohibitions of the Rule become effective with respect to banking entities before July 21, 2010; or (2) two years after the nonbank financial company becomes a banking entity.¹⁹² “Illiquid Funds,”¹⁹³ on the other hand, are given additional time to comply with the Rule and are allowed to request an additional extension of up to five years to meet a contractual obligation in place before May 1, 2010.¹⁹⁴ However, the Private Equity Growth Capital Council has urged the FSOC to grant additional time once a rule is in place because banking entities selling off investments in some funds before the end of their investment terms could lead to significant market disruption.¹⁹⁵

190. *Id.*

191. *Id.*

192. Conformance, 75 Fed. Reg. 72,741, 72,742-43 (proposed Nov. 26, 2010) (to be codified at 12 C.F.R. pt. 225).

193. The Proposed Rule defines an “illiquid asset” as any asset that is not a “liquid asset.” The proposed liquid assets “are designed to capture the wide range of instruments and assets (or their equivalents) that one actively and routinely trades on markets or trading facilities, as for which bid offer or price quotations are widely available.” Also, the Fed retains discretion to include other assets that may be considered liquid, but are not included in the definition. A fund is illiquid if it is “principally invest” in illiquid assets. To be principally invested, “75 percent of the fund’s consolidated assets are, or are expected to be, comprised of illiquid assets or risk-mitigated hedges entered into in connection with, and related to, individual or aggregated positions in, or holdings of, illiquid assets.” *Id.* at 72,744-45.

194. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13(c)(3), 124 Stat. 1376, 1623 (2010) (to be codified at 12 U.S.C § 1851).

195. Many of the private equity funds formed before the enactment of the Rule terminate in 2022 or 2023. Manickavasagam, *supra* note 81.

Because the proposed rule gives ample time for banking entities to conform to the Rule's restrictions, it will help avoid disruption to the financial stability of the United States in the near term.¹⁹⁶ It also increases the possibility that Congress will have time to get rid of portions of the provision or the provision in its entirety.¹⁹⁷ In fact, Republicans intend to put Dodd-Frank "under the microscope,"¹⁹⁸ and the Rule is at the top of their list.¹⁹⁹ Rethinking Dodd-Frank carries huge implications and could result in new congressional debate regarding the costs and benefits of the Rule.²⁰⁰ Although "wholesale" repeal of Dodd-Frank is not on Congress' agenda in the near future, congressional debate on the topic may influence regulators enacting the Rule to minimize the potential negative consequences.²⁰¹ Further, those in Congress have not ruled out statutory changes.²⁰²

V. CONCLUSION

Increasing the safety and soundness of banking entities and the U.S. financial system is an important goal.²⁰³ The Rule, however, imposes substantial costs on U.S. financial stability while doing little to account for this goal.²⁰⁴ Focusing on activities that were not a significant contributor to the financial crisis is not only nonsensical in light of some of their benefits but may pose threats to the financial system that are greater than the benefits of

196. See Conformance, 75 Fed. Reg. 72, 741, 72, 742 (proposed Nov. 26, 2010) (to be codified at 12 C.F.R. pt. 225).

197. See Bruce, *Regulatory*, *supra* note 17; Letter from E. William Parsley III, *supra* note 97 (stating that he does not believe that investing in private funds represents undue risks to banks).

198. Bruce, *Regulatory*, *supra* note 17.

199. See *id.*

200. Because many believe that the Rule is not a necessary portion of financial reform and results in many unintended consequences, there is the prospect that portions of the Rule may be changed in whole or part. See *id.*

201. *Id.*; see also Bruce, *GOP*, *supra* note 125 ("[t]he 2010 midterms will make the rulemaking climate easier for regulators, and more user-friendly for bankers.").

202. See Bruce, *GOP*, *supra* note 125.

203. See *Prohibiting*, *supra* note 5, at 24 (statement of Paul Volcker, Chairman of the President's Economic Recovery Advisory Board and Former Federal Reserve Chairman).

204. Bruce, *Regulatory*, *supra* note 17.

restricting such activities.²⁰⁵ Nonetheless, regulators can mitigate the adverse effects of the Rule by crafting regulations that allow activities that are beneficial to industries adversely affected by the Rule, to banking entities, and to the financial well being of the United States in its entirety.²⁰⁶ Although repeal of the Rule is unlikely at this juncture,²⁰⁷ a failure by regulators to account for the shortcomings of the Rule may provoke Congress to reevaluate the costs and benefits of the Rule, and the long conformance period increases the probability that there will be statutory changes.²⁰⁸

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205. See *Implications*, *supra* note 15, at 10 (statement of Barry Zubrow, Executive Vice President and Chief Risk Officer at JPMorgan Chase) (stating that it would be a “misunderstanding” to believe that these activities led to the financial crisis); Letter from Spencer Bachus, *supra* note 19 (stating that regulators need to take into account the potential devastating effect the Rule may have on U.S competitiveness).

206. See Bruce, *Regulatory*, *supra* note 17; Letter from Lisa J. Bleier, *supra* note 82.

207. Bruce, *GOP*, *supra* note 125.

208. Even though the main focus in Congress will be regulatory action, many believe that there could be changes on the way, and as costs of compliance are coming into focus, the regulations costs could move Congress to mitigate the impact on the financial industry. See *id.*